

Porter, White & Company

Investment Expenses

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Investment expenses can be a significant drag on investment performance. Some investment expenses are easily identified, and others are hidden from view. Authoritative studies of total investment expenses are scarce. The following table presents estimates developed by William J. Bernstein, an investment adviser and well known author in the field of financial economics (Bernstein, 2001).

Average Expenses of Actively Managed Mutual Funds

	Large Cap	Small Cap / International	Emerging Markets
Mutual fund expense	1.30%	1.60%	2.00%
Commissions*	0.30%	0.50%	1.00%
Bid-ask spread*	0.30%	1.00%	3.00%
Market impact*	0.30%	1.00%	3.00%
Total	2.20%	4.10%	9.00%

The starred (*) categories of expense are not visible to the investor. For some types of funds they account for over 50% of expenses. Not included, because they do not relate to specific investments, are other investment related expenses that an investor frequently incurs such as legal, accounting and tax advice, and financial planning and investment advisory expenses.

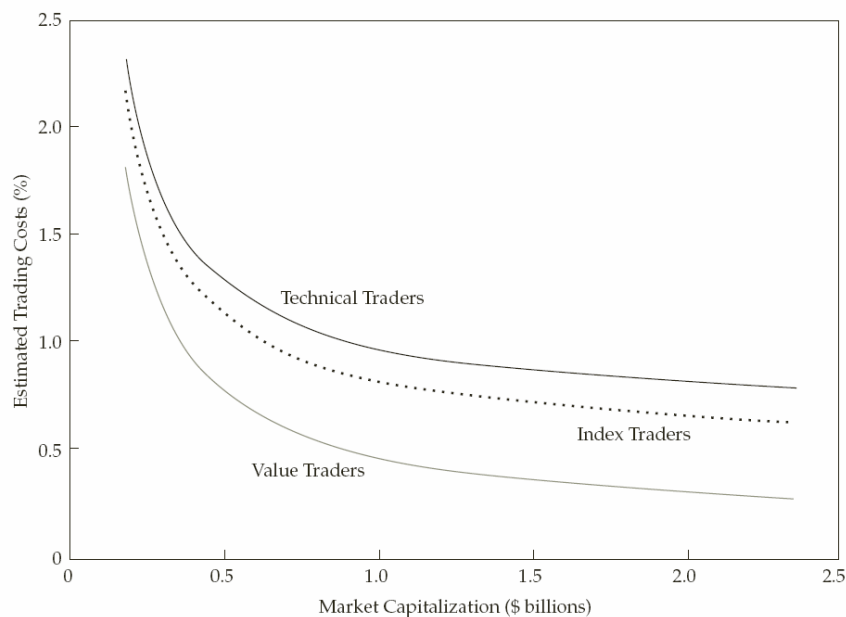
Bernstein does not provide sources for the information in his table. However, published literature generally supporting the Bernstein data include Berkowitz and Logue (2001), Keim and Madhavan (1997), Keim and Madhavan (1998), and Waring (2004). M. Barton Waring, Managing Director and Head of the Client Advisory Group of Barclays Global Investors, one of the largest money managers in the world, states that total trading costs for the typical traditional manager "are almost certainly greater than 1 percent a year and probably a fair bit higher (maybe 35 bps of explicit commissions and spreads for a U.S. equity manager plus 50-125 bps of additional market impact costs...)." Waring (2004), p. 73.

In the table above, *Mutual fund expense* is an estimate of the management fees and other expenses charged by the average actively managed mutual fund and paid out of the assets in the mutual fund. Front or rear-end loads are not included. *Commissions* are brokerage commissions paid by the mutual fund for securities transactions. As discussed below, these commissions may include so-called "soft dollar" costs for research and other services paid for by larger commissions than would otherwise be required for transactions. *Bid-ask spread* is the difference between what the exchanges or over the counter market makers charge to buy or sell a stock. Market makers buy at one price and sell at a higher price. The customers pay the spread. *Market impact* is the price impact of large trades of the type frequently entered by mutual funds. Large

trades tend to move the market, resulting in lower prices on the sell side and higher prices on the buy side.

The following chart from Keim and Madhavan (1998) summarizes some of the academic research done on agency and market impact costs of trades by institutional investors.

**Estimated One-Way Trading Costs by Investment Style
for a Hypothetical Trade in a Nasdaq Stock**



Examination of the chart reveals that the cost of a round trip trade (a sell order followed by a buy order) varies from about .5% to about 4.5%, depending on the size of the stock and the type of trader (manager). Assuming 100% turnover in a portfolio, trades will add anywhere from 50 basis points to 450 basis points to portfolio costs.

Where investors invest through managed accounts, the expense picture is even more opaque and it becomes even more difficult to calculate costs. Until recently prohibited, many mutual fund management companies directed securities trades as compensation for sales effort to brokerage firms that sold their funds. This practice continues for brokers who introduce clients to money managers who manage client funds in separate accounts. Further, in the case of separate accounts, managers tend to report returns before deduction of management fees and expenses, making it difficult to compare returns to competitors.

Applicable law permits fund managers to receive "soft dollars" from brokers to whom they pay commissions to cover such costs as research, electronic data (Bloomberg terminals) and the like, and currently the SEC does not require any disclosures of the amount of these "soft dollars." It is reported that Harold Bradley, Senior Vice President, American Century Investment Management testified before Congress on March 12, 2003 that the "research component of soft dollar commis-

sions costs six times the value of the [trade] execution component." Bullard (2003), p 11. Berkowitz and Logue (2001) estimate that 65% of each commission dollar is either paid for research or rebated, and only the remaining 35% is used to compensate the broker. In the context of a retirement plan, soft dollars can be diverted to pay administrative and other fees.

The chart below identifies all categories of investment cost and indicates those costs that are explicit and those that are usually hidden.

Analysis of Investment Cost

	Specifically Identifiable Costs	Hidden Costs	Description of Costs
Payments known as soft dollars are frequently made by brokers on behalf of investment managers, advisers and consultants and these payments tend to increase trading costs	Investment advisory and consulting fees	<i>(Soft dollars possible)</i>	These are the fees of investment advisers or consultants and include advice on investment policies (and their relation to multi-year financial plans), client education, performance reports, and may include record keeping, including accounting for subsidiary funds (in response to donor constraints).
	Custody fees	<i>(Soft dollars possible)</i>	Paid to an institution to maintain custody of securities and may include record keeping, including accounting for subsidiary funds (in response to donor constraints).
	Management fees	<i>(Soft dollars possible)</i>	Paid to a firm for research and other services relating to the selection, purchase and sale of securities.
	Fund expenses	<i>(Soft dollars possible)</i>	Payment for expenses other than management expenses if investment is through a mutual fund.
	Fund marketing expenses (12b-1 expenses)	<i>(Soft dollars possible)</i>	Payment for marketing expenses of a mutual fund.
		<i>Agency costs (commissions and bid-ask spread)</i>	Commissions or spread (sometimes both) on the purchase or sale of a security.
		<i>Market impact</i>	Change in market value resulting from the purchase or sale of an unusually large block of securities.

Hidden costs are incurred in many ways. Some investment advisers and investment managers benefit from having some of their expenses paid with soft dollars by the brokers with whom they deal. This usually results in increased brokerage commissions (sometimes \$.05 per share rather than \$.01 per share). Some brokers introduce investment managers to institutions and receive compensation through directed portfolio trades, which may be at a higher commission than

would otherwise be possible. Some investment managers do not have the knowledge, skill or clout to tighten bid-ask spreads or lessen market impact. It takes an investment in good people and good systems to do this and these costs must be covered in the investment manager's fees.

Ultimately costs, whether disclosed or hidden, are reflected in performance. However, in order to observe the effect of costs on performance it is necessary to rigorously compute historical returns, taking into account all known costs (unknown costs will be reflected in the returns), and compare them to benchmark portfolios with similar risk and other investment characteristics. In the absence of this type of performance analysis, a comparison of costs is meaningless because so much of the cost of investing is invisible to the investor.

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